No. 79027-2

IN THE SUPREME COURT
OF THE STATE OF WASHINGTON

Court of Appeals No. 55342-9-I

MUTUAL OF ENUMCLAW INSURANCE COMPANY,

Respondent/Cross-Petitioner,

v.

DAN PAULSON CONSTRUCTION, INC., a Washington corporation, KAREN and JOSEPH MARTINELLI, and the marital community composed thereof,

Petitioners/Cross-Respondents.

RESPONSE OF PETITIONERS/CROSS-RESPONDENTS KAREN AND JOSEPH MARTINELLI TO AMICUS CURIAE BRIEF OF WASHINGTON DEFENSE TRIAL LAWYERS

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I. PAULSON DID NOT BREACH ANY DUTY TO MUTUAL OF ENUMCLAW AND THAT ISSUE IS NOT PROPERLY BEFORE THIS COURT; MOREOVER, THE RECORD COMPLETELY REFUTES WDTL'S ATTACKS ON PAULSON.

The Washington Defense Trial Lawyers ("WDTL") blames the insured, Dan Paulson Construction, for the bad faith conduct of the insurer, MOE. See, *e.g.,* WDTL Br., pp. 8, 12, 13, 14, 19 (claiming that Paulson "'manufacture[d]'" or "'concoct[ed]'" these bad faith claims, engaged in "tactical gamesmanship," "obstructed" Mutual of Enumclaw's investigation or tried "to prevent resolution of coverage questions," and entered into a "sweetheart settlement."). The trial court, however, concluded that Paulson did *not* breach any duty to Mutual of Enumclaw, and that issue is not properly before this Court in any event. See, Petitioners' Mot. to Strike, pp. 2-4; *Zuver v. Airtouch Communications, Inc.,* 153 Wn.2d 293, 304 n. 4, 103 P.3d 753 (2004)(Court may decline to issue raised only by amicus).

In any event, this Court should also reject WDTL's attacks against Paulson as pure fiction.[1] Mutual of Enumclaw, *not* Paulson, *unilaterally*

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1 WDTL also represents, as fact "in this case", that Paulson "has no significant assets (beyond the insurance policy) to respond to the claim if it is successful." WDTL Br., p. 13. Petitioners' have not located *any* evidence in the Record that supports WDTL's

chose to delay its own declaratory judgment action and then chose to recklessly interfere in Paulson's defense on the eve of (and during) arbitration, without any notice to or consent by the insured. See, Pet. Supp. Br., pp. 5-7; Pet. for Rev., pp. 11-14; CP 155. Indeed, MOE's choice of delay rendered the declaratory judgment action useless. See, Pet. Supp. Br., pp. 6-7. This quite simply is not a situation in which an insured "set up" the insurer through tactical means. Instead, Mutual of Enumclaw's own failure to resolve its coverage disputes *promptly, in a manner designed to limit prejudice to the insured,* represents a powerful indicia of bad faith in any context. See, *Associated Wholesale Grocers, Inc. v. Americold Corp.,* 934 P.2d 65, 90 (Kan. 1997), *cited with approval, Ortiz v. Biscanin,* 122 P.3d 365, 375, 377 (Kan. App. 2004). MOE, *not* Paulson, created these problems all by itself.

WDTL also wrongly asserts that Paulson "obstruct[ed]" Mutual of Enumclaw's investigation and tried "to prevent resolution of coverage

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representation. WDTL also implies (p. 16) that most or all of the claims against Paulson fell outside coverage; they did not. The record shows claims totaling $2.3-2.67MM against Paulson, *much* of which came *within coverage.* See, CP 38-40 and Resp. Br. in Court of Appeals, pp. 5-6, and 12, for detailed Record references.

questions." WDTL Br., p. 12.[2] To the contrary, Paulson and the Martinellis *fully* cooperated with Mutual of Enumclaw, as Mutual of Enumclaw's own coverage counsel admitted and as the trial court specifically held. CP 649, 971-2. See, Pet. Mot. to Strike, pp. 3-4; Resp. Br. in Court of Appeals, p. 7 (for additional Record references). WDTL also relies on cases involving an insured's failure to provide timely notice of a claim to its insurer for the erroneous contention that "Washington courts repeatedly have held that insured's actions comparable to stipulating to a judgment establish prejudice as a matter of law." WDTL Br., p. 8.[3] To the contrary, this Court has repeatedly approved the use of covenant judgments [see, Pet. Supp. Br., p. 17] and Paulson had every

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2 WDTL (p. 12) quotes a dissenting Justice's footnote in *White v. Western Title Ins. Co.*, 40 Cal.3d 870, 900 n. 2, 710 P.2d 309, 221 Cal. Rptr. 509 (1985). *White* presciently held that an insurer's duty of good faith does *not* end with the onset of litigation because that "would encourage insurers to induce the early filing of suits and to delay serious investigation and negotiation until after the suit [between insurer and insured] was filed when its conduct would be unencumbered by any duty to deal fairly and in good faith."

3 The insured in *Felice v. St. Paul Fire & Marine Ins.*, 42 Wn. App. 352, 711 P.2d 1066 (1985) tried the case *before notifying* the insurer of the claim; the insured in *Northwest Prosthetic & Orthotic Clinic, Inc. v. Continental Ins. Co.*, 100 Wn. App. 546, 997 P.2d 972 (2000) settled the case *before* giving the insurer an opportunity to investigate; the insured in *Key Tronic Corp. v. St. Paul Fire & Marine Ins. Co.*, 134 Wn. App. 303, 139 P.3d 383 (2006) settled the claim *before* notifying the insurer of the claim, and; the insured in *MacLean Townhomes, LLC v. American States Ins. Co.*, __Wn. App. __, 156 P.3d 278 (2007) entered into binding agreements concerning arbitration and tolling *before* it notified the insurer of the claim. Here, the trial court rejected MOE's cooperation clause argument, which MOE abandoned on appeal. See, Pet. Mot. to Strike, pp. 2-4.

right to settle the case because, "[b]y issuing a reservation, an insurer empowers its insured to settle the claim independently, immediately, and without any direct notice to the insurer." T. Harris, *Washington Insurance Law,* §17.7, p. 17-16 (2d ed. 2006), *citing, Evans v. Continental Casualty Co.,* 40 Wn.2d 614, 627-30, 245 P.2d 470 (1952). Accord, *Chaussee v. Maryland Cas. Co.,* 60 Wn. App. 504, 510, 803 P.2d 1339 (1991).

Moreover, the insured's right to control the reservation of rights defense specifically includes the right to seek an undifferentiated judgment. Harris, *supra,* §17.8, p. 17-17. WDTL's proposition (p. 11) that the insured must forego its right to seek an undifferentiated verdict, while being defended under a reservation of rights, would subordinate the insured's interests to those of the insurer. No authority supports WDTL's conclusion, which is contrary to *Tank v. State Farm Fire & Casualty Co.,* 105 Wn.2d 381, 388, 715 P.2d 1133 (1986).

There was also no "sweetheart settlement" in this case. The trial court instead explicitly held that there was *no* fraud or collusion in the settlement [CP 689-90], a conclusion Mutual of Enumclaw has not disputed on appeal. Both the trial court (on summary judgment) and the

highly experienced arbitrator also found the settlement reasonable [CP 179, 690] and covenant judgments are entirely proper.

The record on appeal directly and completely refutes the fundamental factual premises of WDTL's amicus brief.

II. WDTL'S OWN AUTHORITY CONTRADICTS ITS CONTENTION THAT AN INSURER MAY USE LITIGATION TO UNREASONABLY INTERFERE IN ITS INSURED'S RESERVATION OF RIGHTS DEFENSE.

WDTL does not discuss whether Mutual of Enumclaw's interference in the reservation of rights defense meets the applicable legal standard of bad faith, *i.e.*, "unreasonable, frivolous or unfounded" conduct. WDTL instead argues that after an insurer files (but does not serve) a declaratory judgment action, the insurer may interfere with impunity in its insured's reservation of rights defense--by communicating *ex parte* with the arbitrator (or judge) of its insured's reservation of rights defense on the eve of trial, sending that factfinder misleading information about the insured's insurance coverage (*ex parte*, as well), and trying to intimidate the factfinder through a legally-baseless subpoena--*because* the *only* remedy for such conduct in Washington consists of "a motion to strike,

compel discovery, secure a protective order or impose sanctions." WDTL Br., p. 11.[4] WDTL never explains how any of these purported remedies would have solved the many problems Mutual of Enumclaw's misconduct created for Paulson.

Mutual of Enumclaw's "exercise of its legal right to seek relief in the courts" [WDTL Br., p. 10] was not what created the unnecessary risk and uncertainty for Paulson; its pretextual abuse of that right did. See, Pet. Supp. Br., pp. 1-8. WDTL thus misses the point when it broadly asserts that "it cannot be bad faith for an insurer to request relief from a tribunal." WDTL Br., pp. 8-11. Indeed, WDTL's only supporting authority, *Timberlake Const. Co. v. U.S. Fidelity and Guaranty Co.*, 71 F.3d 335 (10th Cir. 1995)(predicting, in diversity, how the Oklahoma Supreme Court would rule in a first-party case) actually *held* that evidence of the insurer's litigation conduct *can* be admitted to prove bad faith in some situations *and* the insurer's position must be "reasonable and legitimate." *Id.* at 340-

4 An ironic juxtaposition exists between WDTL's assertion (*e.g.*, p. 18), that "sanctions" represent an appropriate remedy for insurer misconduct, and its contrary contention that the Court must studiously avoid any "punitive" result. A primary purpose of sanctions is, of course, to punish.

41.[5] Accord, *Vining v. Enterprise Financial Group,* 148 F.3d 1206, 1213 (10th Cir. 1998). The Oklahoma Supreme Court quite recently confirmed that "[a]n insurer may engage in certain *litigation conduct* pursuant to a procedural right *and yet by that act violate its duty to an insured.*" *Brown v. Patel,* 157 P.3d 117 (2007). (Emphasis added).

Thus, prohibiting an insurer from abusing process within the declaratory judgment action to engage in unreasonable, frivolous and unfounded interference in the insured's reservation of rights defense does *not* place the insurer "in an untenable position" [WDTL Br., p. 10], but merely re-affirms this Court's longstanding prohibition against bad faith conduct by insurers.

III. WDTL STANDS THE PRESUMPTION OF HARM ON ITS HEAD.

WDTL's true purpose becomes clear in the final section of its brief, where it asks the Court to "distinguish" Washington's consistent and uniform precedent establishing the presumption of harm and the remedy of coverage by estoppel for an insurer's bad faith. This Court's body of

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5 *Timberlake* involved a first-party claim, as did the two cases it relied upon, *Palmer v. Farmers Ins. Exch.,* 861 P.2d 895 (Mt. 1993)(UIM claim) and *Int'l Surplus Lines Ins. Co. v. Univ. of Wyo. Research Corp,* 850 F. Supp. 1509, 1527-29 (D. Wyo. 1994), *aff'd,* 52 F.3d 901 (10th Cir. 1995). See, Pet. Supp. Br., pp. 1-2.

insurance bad faith jurisprudence has established a practical, coherent, and effective equipoise between the rights and duties of insurers and insureds, from which this Court should not resile without "a clear showing that [it] is incorrect and harmful." *Riehl v. Foodmaker, Inc.*, 152 Wn.2d 138, 147, 94 P.3d 930 (2004)(*stare decisis* standard). Petitioners previously explained why this Court adopted the *Butler* presumption of harm, rather than the *outcome-based* analysis urged by Mutual of Enumclaw. Pet. Supp. Br., pp. 8-14.[6] WDTL, in contrast, stands *Butler* on its head *by presuming the absence of harm and requiring the insured* to prove actual harm, *i.e.*, that "there was no detriment to the insured's defense." WDTL Br., pp. 15 (see also WDTL Br. at 16: "*the Martinellis do not even attempt to show* that there was any detriment to Paulson's defense, and indeed, they cannot possibly do so.")(emphasis added). Compare, Pet. Supp. Br., pp. 11-12. WDTL makes no clear showing that *Butler* is wrong or harmful. The Court should embrace *Butler* rather than emasculate it.

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6 WDTL quotes *J.B. Aguerre, Inc. v. American Guarantee and Liability Ins. Co.*, 59 Cal. App.4th 6, 13-15, 68 Cal. Rptr.2d 837 (1998). WDTL Br., p. 13. *Aguerre*, however, explains that harm includes effects "different from exposure to excess liability," such as injury to the insured's goodwill due to delay in settling customers' complaints, the insurer's settlement of a claim against the insured in a way that prejudice the insured, and using the insured's fear of non-covered claims to coerce the insured into contributing to settlement. *Aguerre*'s analysis of harm thus conflicts with that of MOE and WDTL.

The Court also undoubtedly understands just how disruptive such an unexpected interference would be during final trial preparations—particularly when the insurer's unexpected interference includes *ex parte* communications with the trier of fact concerning the very matters at issue in the insured's case.[7] The insured could *never* prove the impact the insurer's interference caused with the arbitrator or judge because the insured could *never* call the judge or arbitrator as a witness to testify concerning the effects of the insurer's conduct on him/her. *E.g.*, CP 139-140; Pet. for Rev., p. 14. Nor could the insured prove the full impact of the insurer's interference on the reservation of rights defense; nevertheless, why should the insured *ever* be forced to divert its time, attention and resources to defend the integrity of the arbitration or judicial process against outrageous conduct by its insurer on the eve of trial? And how could the insured have resolved the uncertainty as to whether the future

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7 Well-known rules generally prohibit *ex parte* communications with judges, jurors, *and arbitrators.* RPC 3.5(a), (b) and (c); CJC Canon 3 and Comment to Canon 3(A)(4). See, *Discipline of Carmick,* 146 Wn.2d 582, 595 and n. 4, 48 P.3d 311 (2002); *Valrose Maui, Inc. v. Maclyn Morris, Inc.,* 105 F. Supp.2d 1118, 1123-4 (D. Haw. 2002)(*ex parte* communication violated Federal Arbitration Act section identical to RCW 7.04.160(2) *even without showing actual bias or improper motive*); *Cabbad v. TIG Ins. Co.,* 751 N.Y.S.2d 871 (2002)(vacating arbitration award due to *ex parte* communication); ABA Annot. Model Rules of Professional Conduct, RPC 3.5, p. 339 (3d ed. 1996), citing Phila. Bar Ass'n Ethics Op. 95-8 (lawyers may not communicate *ex parte* with arbitrator). Accord, CP 176 (AAA Rule R-19).

arbitration award would withstand scrutiny at confirmation under such circumstances, without actually enduring the risks of litigating that very issue to conclusion? As the Court of Appeals noted in *Transamerica Ins. Group v. Chubb & Son, Inc.*, 16 Wn. App. 247, 250-52, 554 P.2d 1080 (1976), "**[t]he course cannot be rerun, no amount of evidence will prove what might have occurred if a different route had been taken.**" (Emphasis added). These are *precisely* the types of harm *Butler* seeks to discourage—and which WDTL would have this Court condone. Pet. Supp. Br., pp. 8-10.

IV. COVERAGE BY ESTOPPEL IS A REMEDY AT LAW; RECHARACTERIZING IT AS AN "EQUITABLE" REMEDY WOULD EVISCERATE THIS COURT'S BRIGHT LINE RULES.

Insurer bad faith constitutes a tort in Washington, for which harm is an essential element; coverage by estoppel thus represents a remedy at law, not equity. See, Pet. Supp. Br., pp. 8-10. WDTL nevertheless insists that "estoppel [to deny coverage] has its genesis in equity." WDTL Br., p. 18. If estoppel to deny coverage were an equitable remedy, this Court would review its application by the trial court for an abuse of discretion. *E.g., Sorensen v. Pyeatt,* 158 Wn.2d 523, 531, 146 P.3d 1172 (2006).

This Court adopted the remedy of coverage by estoppel based upon traditional tort principles of deterrence and public policy. *Safeco Ins. Co. of America v. Butler,* 118 Wn.2d 383, 392-94, 823 P.2d 499 (1992). WDTL's attempt to recast the remedy of estoppel to deny coverage as "equitable" would require trial courts to first weigh whether particular acts of bad faith, individually or taken together, constitute ordinary bad faith—or "super" bad faith sufficient to potentially warrant coverage by estoppel. This Court has already rejected that argument. *Besel v. Viking Ins. Co.,* 146 Wn.2d 730, 737, 49 P.3d 887 (2002)("The principles in *Butler* do not depend on how an insurer acted in bad faith. Rather, the principles apply whenever an insurer acts in bad faith").

If the insured met WDTL's "super" bad faith standard, WDTL would still require the courts to engage in the zero-sum game of determining whether the economic harm caused to the insured outweighed the insurer's liability. However, this Court has already rejected that argument as well. *Butler, supra,* 118 Wn.2d at 394 ("This would render *Tank* meaningless"). Thus, in WDTL's scenario, insurers would always gamble because the remedy imposed for bad faith is worth the risk. This

Court should therefore strongly re-affirm its commitment to *Butler* and not start down the slippery slope urged by WDTL.

CONCLUSION

This Court should rely on the record, not the imaginary "facts" posited by WDTL. The Court should also re-affirm its commitment to the well-established balance between the rights and obligations and insurers and their insureds.

Respectfully submitted this 25th day of May, 2007.

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